Hong Kong (SAR) Tax Alert

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The draft legislation on the foreign-sourced income exemption regime was passed

Summary

The draft legislation on the revised foreign-sourced income exemption (FSIE) regime in the Hong Kong SAR (Hong Kong) and its subsequent amendments proposed by the government were passed by the Legislative Council on 14 December 2022.

The corresponding ordinance is expected to be gazetted on 23 December 2022. Upon gazettal of the ordinance, the FSIE regime will be effective from 1 January 2023.

The Inland Revenue (Amendment) (Taxation on Specified Foreign-sourced Income) Bill 2022 (the Bill)[1] was gazetted on 28 October 2022. Based on the comments of the European Union (EU) on the Bill, the HKSAR government subsequently proposed certain amendments[2] (as Committee Stage Amendments) to the Bill. The Bill and all the proposed amendments were passed by the Legislative Council on 14 December 2022.

For a more detailed discussion of the FSIE regime and our observations on some key issues, please refer to our previously issued Hong Kong (SAR) Tax Alert - Issue 21, October 2022, Hong Kong (SAR) Tax Alert - Issue 24, November 2022 and Hong Kong (SAR) Tax Alert - Issue 26, December 2022.

Major amendments to the Bill

The major amendments to the Bill proposed by the government and passed by the Legislative Council are:

- Deleting the definition of "excluded entity" (i.e. there will no longer be a list of excluded entities that are out of scope of the FSIE regime) and the consequential changes.
- Excluding the following income from "specified foreign-sourced income" by amending its definition (i.e. the excluded income approach):
  – foreign-sourced interest, dividends and equity disposal gains derived from or incidental to the profit-producing activities as required under a preferential tax regime with a substantial activities requirement[3]; and
  – foreign-sourced interest, dividends and equity disposal gains accrued to an entity that has derived any exempt sums under the tax regime for ship-owner business.
- Minor textual changes to the Chinese version of the Bill.

1 The Bill can be accessed via this link: https://www.gld.gov.hk/egazette/pdf/20222643/es32022264319.pdf
2 A list of amendments to the Bill and a consolidation version of the Bill can be accessed via this link: https://www.legco.gov.hk/yr2022/english/bc/bc06/papers/bc06cb1-819-1-e.pdf
3 These regimes currently include (1) the preferential tax regimes for corporate treasury centres, certain insurance businesses, aircraft leasing, ship leasing, certain maritime service providers and carried interest, (2) the unified fund exemption regime and (3) the tax exemption regime for non-resident persons.

The "headline rate approach" under the participation exemption

During the legislation process, the HKSAR government also indicated that an agreement was reached with the EU to adopt the "headline rate" approach (i.e. the highest corporate tax rate of the relevant foreign jurisdiction instead of the actual tax rate imposed on the income concerned will be considered) to determine whether the "15% subject to tax" condition of the participation exemption is met[4].

While the Inland Revenue Department (IRD) has yet to update the administrative guidance on its website to illustrate the application of the "headline rate approach", it is understood that the following would apply:

Scenarios	Whether the "15% subject to tax" condition is met?
1. Gain derived from disposal of a Chinese company that is taxed at 10% (the highest corporate income tax (CIT) rate in China is 25%)	Yes, as the disposal gain is subject to tax in China and the highest CIT rate in China is ≥ 15%
2. Gain derived from disposal of a Chinese company that is exempt from tax in the Mainland under the double tax arrangement between the Mainland and Hong Kong	No, as there is no actual tax liability on the disposal gains
3. Capital gain derived from disposal of a Singaporean company that is exempt from tax in Singapore (the highest CIT rate in Singapore is 17%)	No, as there is no actual tax liability on the disposal gains

Effective date

It is expected that the corresponding ordinance on the FSIE regime will be gazetted on 23 December 2022. Upon gazettal of the ordinance, the FSIE regime in Hong Kong will be effective from 1 January 2023 (i.e. applicable to specified foreign-sourced income **accrued and received on or after 1 January 2023**).

KPMG observations

Despite the passage of the Bill and the proposed amendments, there are open issues surrounding the practical interpretation and application of the FSIE regime. It is expected that the IRD will update the existing administrative guidance and issue a Departmental Interpretation and Practice Note to provide more guidance and examples for illustrating how the FSIE regime will be applied and administered in practice.

Given the effective date of the FSIE regime is fast approaching, impacted business groups in Hong Kong should proactively assess the impact of the FSIE regime on their businesses and explore possible options to mitigate the potential Hong Kong tax exposure. If they wish to obtain certainty on issues other than compliance with the economic substance requirements under the regime, they can consider applying for an advance ruling after the regime becomes effective (i.e. on or after 1 January 2023).

4 Please refer to the letter in this link for details: https://www.legco.gov.hk/yr2022/english/bc/bc06/papers/bc06cb1-833-1-e.pdf

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